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What to do with Required Minimum Distributions?

Market News and IRA Strategies

Since the Fiscal Crisis, growth in the economy and markets has been met with a certain amount of skepticism. Until 2013, investment dollars flowed to bonds over stocks by about a 4:1 margin even as the S&P500 increased nearly 150%. This is a measure of uncertainty in the minds of investors who were seeking the traditional stability of debt instruments over the volatility of equities. This situation still hasn't changed much in the last five years as rising equity valuations have raised expectations for the next market correction and investors continue buying bonds. Rising rates may present a challenge.

Are Stocks Still an Attractive Asset?

It wasn't that long ago, I was writing about the "new normal" of below average economic growth for the foreseeable future. We were told the days of 3%/yr GDP growth were behind us. Those were the expectations as recently as 2 ½ years ago. Tax cuts, reduced regulation, and repatriation of overseas wealth have combined to improve consumer optimism and the economic outlook.

There has been a strong trend of rising GDP growth over the last year or so. The first quarter of 2018 measured 2.8% GDP growth over the prior year and the second quarter registered over 4% in year-over-year growth! The foreseeable future still shows an improving economic outlook—potentially back to historical growth rates of 3-4%.

This Year and Looking Forward

2018 has been a year with some extremes. We've seen some significant point movements in the markets—the Dow Jones Industrial Average had its largest point drop in history at the end of January and last quarter showed the best return for the S&P500 in over five years. October has been rough but the major indices remain positive for the year so far.

We entered the year with a hot stock market headed to high PE ratios. The sideways movement of the market combined with record earnings has lowered the forward-looking PE ratio to less than the long-term averages. In other words, despite some growth and volatility this year, equities have become even more attractive as an investment asset. Expectations call for this trend to continue for the foreseeable future. Even with these expectations, investors should prepare for "normal" to include elevated volatility. A balanced approach will help to smooth out the bumps.

Given the modest changes in the markets, let's talk about a different subject… dealing with required distributions from retirement accounts. There are strategies you should know.

RMD Basics

Required Minimum Distributions, often referred to as RMDs or even Minimum Required Distributions are amounts the Federal government requires investors to remove from traditional IRAs and employer-sponsored retirement plans after reaching the age of 70 ½. There are some cases where the timing is delayed until after the participant retires. Investors can always take more than the minimum but will be heavily taxed if required amounts are not removed.

The RMD rules are designed to spread out the distribution of the entire interest in an IRA or plan account over a lifetime. The purpose is to ensure that assets don't just accumulate tax-deferred but will actually generate taxable income during the lifetime of a plan participant. Since these accounts deferred taxation, the rules ensure the government eventually receives some tax revenue from the assets.

The first required distribution is for the year when the participant reaches the age of 70 ½. This first one may be delayed until April 1 of the following year. All other distributions occur by the end of the calendar year. If a participant delays the first distribution, two will be taken by the end of that year.

There are two situations in which the required beginning date can be later than what's described above… the first is participants continuing to work and participate in their employer's retirement plan. This starting date can be as late as April 1 of the year following retirement (if the plan allows it and the participant owns less than 5% of the company). The second situation is described later (QLAC).

RMDs are calculated by dividing the prior end-of-year account balance of the plan assets by a life expectancy factor specified in IRS tables. Every plan participant's calculation is based on the same assumption… with one exception. If the spouse of the participant is the sole beneficiary of the plan and more than 10 years younger than the participant, they use a different table which stretches the payments out over a longer period.

If there is more than one IRA and plan account, an RMD is calculated for each account but the required amount may

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be removed from any one or more of the accounts. Inherited IRAs are handled separately for this purpose.

RMD rules do not apply to Roth accounts unless inherited.

Should the First RMD be Delayed?

The first decision with RMDs is deciding when to take the first one since you can delay this one until the following April 1. Will the participant have lower income the following year? Will the addition of the second RMD that year push income into a higher marginal tax bracket? These types of considerations should be evaluated based on individual tax situations.

What if RMDs Aren't Taken?

Participants can always withdraw more than the minimum required from their qualified accounts. However, failing to take the RMD for any year (or taking it too late) will result in a federal penalty. The penalty is a 50% excise tax on the amount of the RMD not satisfied. This is a hefty penalty and strong incentive to ensure the RMD is taken on time. What if participants don't want or need their RMDs?

Delaying some RMDs with the QLAC

A participant may be able to use up to 25% of non-Roth IRA and retirement plan account balances (up to a maximum of $125,000 from all accounts, indexed for inflation) to purchase a qualified longevity annuity contract (QLAC). The value of the QLAC is disregarded when calculating annual RMDs. Payments from the QLAC may be delayed up to age 85 and are treated as satisfying RMD rules when paid out.

The rules can be complicated and QLACs are not right for everyone so consultation with qualified professionals is recommended.

Qualified Charitable Distributions-QCD

The Pension Protection Act of 2006 first allowed taxpayers age 70 ½ or older to make tax-free charitable donations directly from their IRAs. Technically, these taxpayers were allowed to exclude from gross income otherwise taxable distributions from their IRA ("qualified charitable distributions," or QCDs), up to $100,000, that were paid directly to a qualified charity. These gifts are also known as "Charitable IRA rollovers." The law was originally scheduled to expire in 2007, but was extended periodically through 2014 by subsequent legislation, and finally made permanent by the Protect Americans from Tax Hikes (PATH) Act of 2015.

The account owner must be 70 ½ or older in order to make QCDs. Direct the IRA trustee to make a distribution *directly* from the IRA (other than SEP and SIMPLE IRAs) to a qualified charity. The distribution must be one that would otherwise be taxable. Up to $100,000 of QCDs may be excluded from gross income each year, thereby avoiding taxation on those amounts. If filing a joint return, a spouse may exclude an additional $100,000 of QCDs. Note: QCDs may not also be deducted as charitable contributions on federal income tax returns—that would be double-dipping.

QCDs count toward satisfying any required minimum distributions (RMDs) that would otherwise have to be received from an IRA, just as if an actual distribution had been received from the plan. However, distributions actually received from an IRA (including RMDs) subsequently transferred to a charity cannot qualify as QCDs.

As indicated above, a QCD must be an otherwise taxable distribution from your IRA. If you've made nondeductible contributions, then normally each distribution carries with it a pro-rata amount of taxable and nontaxable dollars. However, a special rule applies to QCDs—the pro-rata rule is ignored and your taxable dollars are treated as distributed first. (If you have multiple IRAs, they are aggregated when calculating the taxable and nontaxable portion of a distribution from any one IRA.

Without this special rule, taking a distribution from an IRA and donating the proceeds to a charity would be a bit more cumbersome, and possibly more expensive. A distribution would come from the IRA, and then be made a contribution to the charity. The participant would receive a corresponding income tax deduction for the charitable contribution, if itemizing. However, the additional tax from the distribution may be more than the charitable deduction, due to the limits that apply to charitable contributions under Internal Revenue Code Section 170. QCDs avoid all of this, by providing an exclusion from income for the amount paid directly from an IRA to the charity—the IRA distribution isn't reported as gross income, and it doesn't become a deduction for the QCD. The exclusion from gross income for QCDs also provides a tax-effective way for taxpayers who don't itemize deductions to make charitable contributions—especially with this year's increase to the standard deduction.

Summary

My investment outlook favors equities over bonds. This is an environment for strong investment managers and careful stock selection. Income-oriented investments may struggle in a low—and eventually rising—interest rate environment. I think investors doggedly holding traditional debt instruments will find that there are more ways to lose money in bonds than through issuer default.

What to do now? **Take the long view with your investment assets** and dust off financial plans. When was the last time you reviewed your plans? Your estate plan should be reviewed at least bi-annually and updated with every change of life. Most importantly, make sure you have carefully delegated who will execute your documents for you. To review existing planning documents or build new plans, make a resolution to work with an advisor this year.